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Research Update:

Russia's 'BB+' Foreign Currency And 'BBB-' Local Currency Ratings Affirmed; Outlook Negative

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Overview

- In our opinion, Russia is maintaining its external buffers, albeit by the sharp deleveraging of external debt because of its limited access to external financing, and a steep contraction in imports due to the recession and depreciating currency.
- We expect a 1.4% GDP contraction this year, before the economy returns to modest positive growth in 2017.
- We are therefore affirming our ratings on Russia.
- The negative outlook reflects our view that limited access to external funding could undermine economic activity in the corporate and banking sector and put renewed pressure on Russia's foreign exchange reserves.

Rating Action

On March 18, 2016, Standard & Poor's Ratings Services affirmed its 'BB+/B' long- and short-term foreign currency sovereign credit ratings and its 'BBB-/A-3' long- and short-term local currency sovereign credit ratings on Russia. The outlook on both the local and foreign currency long-term ratings remains negative.

We also affirmed the long-term national scale rating on Russia at 'ruAAA'.

Rationale

The ratings reflect our expectation that the Russian economy and the government’s policy-making will adjust such that Russia will continue to maintain its strong net external asset position and modest net general government debt burden in 2016-2019. In our opinion, the ratings remain constrained by the weak political institutions that impede the economy's competitiveness, investment climate, and business environment. Partly as a result of policy-making inertia, in our view, Russia's economy began to slow down earlier this decade, before sanctions and the sharp fall in oil prices. We project muted economic growth in 2016-2019.

We assume an average Brent oil price of US$40 per barrel (/bbl) in 2016, US$45/bbl in 2017, and US$50/bbl in 2018 and thereafter. In Russia, the hydrocarbon sector accounted for about 50% of exports in 2015, down from 58% in 2014, owing to the sharp fall in oil prices. In terms of GDP, the ratio is more difficult to estimate. The share of mining and quarrying in GDP was almost 8% in 2014 and 8.8% in 2015, but when one also includes the value-added of other sectors, such as transport (pipelines) and wholesale trade, we estimate the hydrocarbon sector's contribution rises to 20%-25%. Oil and gas revenues were 43% of central government revenues in 2015, down from 51% in 2014.

We expect that declining domestic purchasing power, as a result of exchange-rate depreciation and elevated inflation, will hamper Russia's growth prospects. We project Russia's real GDP per capita growth will average less than similarly wealthy economies over our 2016-2019 rating horizon. It also reflects the lack of external financing, which has emerged because of economic sanctions and the sharp decline in oil prices. We expect real GDP growth to average 0.5% in 2016-2019, and our GDP per capita estimate for 2016 is US$7,700.

We assume in our base case that the sanctions on Russia will remain in place over our forecast horizon, absent a resolution of the conflict in Ukraine. However, the situation remains fluid and, should sanctions ease, one possible consequence could be a boost to the Russian economy.

In our view, the Central Bank of Russia's (CBR) introduction of a flexible exchange rate regime on Nov. 10, 2014, should afford the CBR greater ability to conserve its foreign currency reserves. The flexible exchange rate regime provides a mechanism via which the economy can adjust to oil price movements. The sharp ruble depreciation, which is currently trading around RUB71 to the U.S. dollar, compared with about RUB35 in mid-2014, supports the local currency value of government oil revenues, which are priced in dollars. Historically, there has usually been a strong correlation between the external value of the ruble and oil prices, and this has held true over the past 12 months.

Balance-of-payment pressures have hit the economy following the decline in oil prices (the Urals oil price currently trades at an about US$3/bbl discount to Brent). Russia is experiencing a severe terms-of-trade shock. We nevertheless expect that Russia's current account will remain in surplus, thanks to a consistent drop in import demand and a reduction in the deficit on the income balance due to falling debt interest payments. We expect a current account surplus equivalent to 3.5% of GDP in 2016. Russia's external debt stock (excluding debt liabilities to direct investors) declined to US$385 billion as of Dec. 31, 2015, from US$466 billion a year earlier, as international capital market financing to Russia remains limited following sanctions.

We note that most of the deleveraging over the period related to debt repayments by the banking sector (49% of the total decline in external debt) and corporate sectors (39%). Banking accounts for 34% and the corporate sector 54% of total external debt. We estimate Russia's external debt service at about US$100 billion in 2016 compared with about US$155 billion in 2015. We expect the CBR's provision of foreign currency liquidity to the domestic banks via repo operations to continue to support private-sector external debt service, while external deleveraging is also supported by corporate external earnings.

External interest payments, reflected in the income balance, have fallen sharply as a result. Russia maintains a net external asset position. We expect liquid external assets held by the public and banking sectors to exceed Russia's external debt by about 30% of current account receipts (CARs) on average over 2016-2019.

Balance-of-payment pressures have centered on the financial account. Private-sector net capital outflows averaged US$57 billion annually over 2009-2013 and increased to US$153 billion in 2014. However, these outflows totaled US$57 billion in 2015, in line with the historical average. Nevertheless, in our view, stress could mount for Russian corporations and banks that have foreign currency debt-service requirements without a concomitant foreign currency revenue stream. That said, the CBR has been providing substantial foreign currency liquidity to domestic banks via repo operations, which has reduced the central bank's headline reserves. We note that the CBR's reverse foreign currency liquidity operations with resident banks were at about $20 billion in March 2016, compared with US$25 billion at the end of December 2015.

We estimate Russia's gross external financing requirement for 2016 at just over 70% of CARs plus usable reserves. Our figure for CBR-usable reserves deducts foreign currency investments made by the CBR on behalf of the government (about US$100 billion in 2015) from the bank's reported foreign currency reserves (US$368 billion). By this definition, we forecast reserve coverage of current account payments at more than seven months.

We project that the general government deficit will average about 3.5% of GDP in 2016-2019. Ruble depreciation supports the central government's fiscal position because its hydrocarbon revenues are mostly priced in U.S. dollars. The general government posted a deficit of 3.6% of GDP in 2015; the central government deficit was 2.4% of GDP; the local and regional government deficit was 0.2% of GDP; and there was a deficit of 0.9% on the social security balance due to a one-off transfer made from the state pay-as-you-go pension system to the private pension fund.

We expect the general government deficit to widen to 4.4% of GDP in 2016. This incorporates our opinion that the central government deficit will reach 3.8% of GDP, the deficit at the local and regional government level will widen to 0.7% of GDP, and the social security system will largely return to balance. Our central government deficit estimate for 2016 includes our expectation that the government will spend 0.3% of GDP in recapitalizing Vnesheconombank. We expect the government to present an amended budget to the parliament in the second quarter of 2016, which incorporates the current market conditions.

The modest general government net debt position is a rating strength, as is the government's low interest burden as a percentage of revenues. The central government's Reserve Fund and National Wealth Fund together totaled about 11% of GDP in 2015. We adjust the level of these assets downward by about 2 percentage points of GDP, due to what we consider non-liquid investments. In our opinion, the central government will progressively liquidate a substantial portion of its assets to fund upcoming fiscal deficits and to increase its support to the economy and the financial system. We project the government's net debt position will rise to 13% of GDP by 2019.

Russia's financial system has weakened, which limits the CBR's ability to transmit monetary policy. In our opinion, the CBR faces difficult monetary policy decisions while it targets inflation of 4% in 2017 and at the same time attempts to support sustainable GDP growth. These challenges result from the inflationary effects of exchange-rate depreciation and sanctions from the West, as well as the counter-sanctions imposed by Russia.

We anticipate that asset quality in the financial system will deteriorate, given the economic recession in 2015 and 2016, the weaker ruble, and pressure on available funding due to reduced investor confidence and restricted access of key areas of the economy to international capital markets due to sanctions.

In December 2014, the CBR increased its key interest rate by 750 basis points over five days to 17%. This was to stem the sharp depreciation of the ruble and curb inflation. The CBR has since reduced its key rate to 11% to support economic growth. The interest rate on interbank loans increased substantially in December 2014, to well above the key rate, although it has since moderated. We see such movements in financial instrument rates as strong indicators of a weak monetary transmission mechanism. We expect that credit to the economy will be curtailed, which will likely further undermine growth. Given the pass-through of more expensive imports to domestic prices generally, we expect annual average inflation to remain elevated, at about 9% in 2016, but reduced from 16% in 2015.

We view Russia's institutional and governance effectiveness as a rating weakness. Political power is highly centralized with few checks and balances, in our opinion. We do not currently expect that the government will be able to effectively tackle the long-standing structural obstacles to stronger economic growth (perceived corruption, the weak rule of law, the state's pervasive role in the economy, and the challenging business and investment climate) over our 2016-2019 forecast horizon.

Outlook

The negative outlook reflects our view that the limited access to external funding could affect economic activity in the corporate and banking sector and put renewed pressure on Russia's foreign exchange reserves. A failure to reinvigorate the economy could further undermine Russia's creditworthiness. We could also lower the ratings if geopolitical events were to result in foreign governments significantly tightening their sanctions on Russia, a scenario that we currently consider unlikely.

We could revise the outlook to stable if Russia's market access were to broaden and financial stability and economic growth prospects improved more significantly than we currently forecast, possibly due to a loosening of sanctions or a rise in the oil price above our current assumptions. Measures to arrest long-term fiscal challenges caused by Russia's adverse demographic profile (a shrinking working age population) could also contribute to stabilizing the rating.

Key Statistics

Table 1

Russian Federation Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	46,309	59,698	66,927	71,055	77,893	80,413	84,526	90,920	96,612	102,660
Nominal GDP (bil. $)	1,525	2,032	2,170	2,232	2,030	1,320	1,127	1,212	1,288	1,369
GDP per capita (000s $)	10.7	14.2	15.2	15.6	14.1	9.0	7.7	8.3	8.8	9.3
Real GDP growth	4.5	4.3	3.5	1.3	0.7	(3.7)	(1.3)	1.0	1.2	1.2
Real GDP per capita growth	4.4	4.3	3.4	1.1	0.5	(5.5)	(1.4)	0.9	1.1	1.1
Real investment growth	5.9	9.1	6.0	0.9	9.9	(7.6)	(5.0)	3.0	1.5	1.5
Investment/GDP	21.7	23.1	22.9	20.7	21.0	18.4	20.3	20.4	20.4	20.4
Savings/GDP	26.1	27.9	26.2	22.3	23.9	23.2	23.8	23.9	23.6	23.2
Exports/GDP	29.2	28.3	27.4	26.6	27.6	29.4	28.9	28.5	27.6	26.8
Real exports growth	7.0	0.3	1.4	4.8	0.3	3.1	0.5	1.0	2.0	2.0
Unemployment rate	7.3	6.5	5.5	5.5	5.2	5.7	6.2	5.9	5.0	5.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	4.4	4.8	3.3	1.6	2.9	4.8	3.5	3.5	3.1	2.8
Current account balance/CARs	13.8	15.4	10.9	5.3	9.3	14.2	9.9	10.2	9.3	8.6
Trade balance/GDP	9.6	9.7	8.8	8.2	9.3	10.7	9.8	9.6	9.0	8.4
Net FDI/GDP	(0.6)	(0.6)	0.1	(0.8)	(1.7)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
Net portfolio equity inflow/GDP	(0.4)	(0.5)	0.0	(0.3)	(0.7)	(0.7)	(0.7)	(0.9)	(0.9)	(0.9)
Gross external financing needs/CARs plus usable reserves	67.1	67.5	70.2	75.8	75.2	76.1	72.8	74.2	76.5	77.7
Narrow net external debt/CARs	(40.0)	(35.6)	(34.3)	(24.9)	(26.5)	(44.3)	(39.7)	(29.1)	(27.9)	(19.0)
Net external liabilities/CARs	(3.6)	(22.9)	(21.0)	(20.2)	(49.4)	(82.5)	(101.6)	(102.8)	(106.7)	(109.7)
Short-term external debt by remaining maturity/CARs	20.6	22.1	22.6	26.1	24.5	30.9	32.1	29.2	27.2	23.8
Reserves/CAPs (months)	8.2	8.2	8.0	7.5	7.0	7.5	9.0	8.0	7.2	6.3
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.4)	1.4	0.4	(1.2)	(1.1)	(3.6)	(4.4)	(3.7)	(2.9)	(2.4)
Change in debt/GDP	2.0	1.9	1.2	1.5	3.0	0.9	1.7	1.1	1.0	2.4
Primary balance/GDP	(2.9)	2.0	1.0	(0.6)	(0.4)	(2.6)	(3.4)	(2.7)	(1.9)	(1.4)
Revenue/GDP	34.6	34.9	35.0	34.4	34.4	33.4	35.0	35.3	35.2	35.2
Expenditures/GDP	38.0	33.5	34.6	35.6	35.4	37.0	39.4	39.0	38.1	37.6
Interest /revenues	1.6	1.6	1.6	1.8	2.0	2.8	2.8	2.9	2.9	3.0
Debt/GDP	10.3	9.9	10.0	10.9	13.0	13.5	14.6	14.7	14.9	16.4

Table 1

Russian Federation Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Debt/Revenue	29.8	28.4	28.7	31.7	37.8	40.5	41.8	41.6	42.2	46.5
Net debt/GDP	(0.9)	(1.8)	(1.9)	(0.5)	(1.7)	0.4	5.1	8.5	10.9	12.6
Liquid assets/GDP	11.2	11.8	11.9	11.4	14.7	13.1	9.5	6.2	4.0	3.7
MONETARY INDICATORS (%)										
CPI growth	6.9	8.4	5.1	6.8	7.8	15.5	8.5	5.7	5.7	5.7
GDP deflator growth	14.2	23.6	8.3	4.8	8.8	7.3	6.5	6.5	5.0	5.0
Exchange rate, year-end (LC/$)	30.48	32.20	30.37	32.73	56.26	72.88	80.00	80.00	80.00	80.00
Banks' claims on resident non-gov't sector growth	13.0	28.9	19.5	17.4	27.0	7.6	7.1	7.0	7.0	7.0
Banks' claims on resident non-gov't sector/GDP	41.0	41.0	43.7	48.3	56.0	58.3	59.4	59.1	59.5	60.0
Foreign currency share of claims by banks on residents	16.7	16.0	13.0	13.6	19.5	28.8	31.0	31.0	31.0	31.0
Foreign currency share of residents' bank deposits	27.5	24.8	26.5	27.8	39.2	41.2	41.0	41.0	41.0	41.0
Real effective exchange rate growth	9.0	4.9	1.5	1.8	(8.4)	(17.5)	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Russian Federation Ratings Score Snapshot

Key rating factors	
Institutional assessment	Weakness
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Strength
Monetary assessment	Neutral

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- General Criteria: Standard & Poor's National And Regional Scale Mapping Tables - January 19, 2016
- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- How The Slump In Oil Prices Is Altering Standard & Poor's View Of Hydrocarbon Exporters' Sovereign Credit Ratings, March 2, 2016
- CIS Sovereign Debt Report 2016: Commercial Borrowing To Decrease To $23 Billion, February 29, 2016
- Russia Faces A Second Year Of Recession, February 25, 2016
- Russian Federation 'BB+/B' FC And 'BBB-/A-3' LC Ratings Affirmed On External Buffers; Outlook Negative, February 17, 2016
- Sovereign Ratings And Country T&C Assessments - February 12, 2016
- Russian Local And Regional Governments' Borrowing Will Increase On Weak Revenues And Higher Spending - February 10, 2016
- Commonwealth of Independent States Sovereign Rating Trends 2016 - January 18, 2016
- Banking Industry Country Risk Assessment Update: January 2016 - January 14, 2016
- S&P Lowers Its Hydrocarbon Price Deck Assumptions On Market Oversupply; Recovery

Price Deck Assumptions Also Lowered - January 12, 2016
- Global Sovereign Rating Trends 2016 - January 06, 2016
- Calendar Of 2016 EMEA Sovereign, Regional, And Local Government Rating Publication Dates - December 22, 2015
- Sovereign Risk Indicators - December 14, 2015; an interactive version is available at http://www.spratings.com/SRI
- Credit FAQ: What's Ahead For Emerging Market Sovereigns In 2016 - December 10, 2015
- 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- How Currency Depreciation In The EMEA Region Is Raising Risks For Banks - October 01, 2015
- Banking Industry Country Risk Assessment: Russia - September 16, 2015
- 2014 Annual Sovereign Default Study And Rating Transitions - May 18, 2015
- Government Support Is Critical To The Stability Of The Russian Banking Sector - February 25, 2015
- Plummeting Prices Weigh on Ratings For Some Oil Exporting Sovereigns - February 11, 2015
- Research Update: Russia Foreign Currency Ratings Lowered To 'BB+/B'; Outlook Negative - January 26, 2015
- Russia's Economic Risks Will Compound Weak Local And Regional Government Finances - December 10, 2014
- Risks Mount For A Longer Downturn In Russia - October 8, 2014
- The Fallout Between Russia And The West Puts European Corporates In A Bind - September 18, 2014
- Sanctions Will Increasingly Weigh On Russian Banks' Funding And Liquidity Profiles - September 18, 2014
- Understanding Standard & Poor's Russia National Scale Ratings - September 14, 2014
- Common Characteristics Of Rated Sovereigns Prior To Default - January 17, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Russian Federation		
Sovereign Credit Rating		
Foreign Currency	BB+/Negative/B	BB+/Negative/B
Local Currency	BBB-/Negative/A-3	BBB-/Negative/A-3
Russia National Scale	ruAAA/--/--	ruAAA/--/--
Transfer & Convertibility Assessment	BB+	BB+
Senior Unsecured		
Foreign Currency	BB+	BB+
Local Currency	BBB-	BBB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information.

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.